

Internal Revenue Service  
**memorandum**

CC:TL

Br3:RARowley

date: **JUN 02 1986**

to: James F. Kidd, Special Trial Attorney, Chicago

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This refers to your memorandum of March 10, 1986, requesting technical advice in the above-referenced case with respect to the issues listed below. It is our understanding that the case is not calendared for trial, and is being held in abeyance pending clarification of the Service's litigating position on the two issues as to which technical advice is requested.

ISSUES

(1) Whether the Service's downward adjustments to taxpayer's "unpaid losses" under I.R.C. section 832(b)(5)(B), based on the "closed claim" method of testing a casualty insurance company's unpaid losses, are defensible in light of data for the test period years indicating that, when in addition to payments on closed claims, partial payments on open claims and payments with respect to incurred but not reported losses are taken into account, the unpaid losses claimed by taxpayer for the test years were understated. 0832.06-00.

(2) Where for years prior to [REDACTED] taxpayer claimed and was allowed, both for annual statement and federal income tax purposes, unpaid losses on [REDACTED] workmen's compensation claims computed without use of a discount factor, but in [REDACTED], for annual statement purposes but not for federal income tax purposes, changed to a method of computation utilizing a discount factor of [REDACTED] percent compounded annually, whether the Service correctly determined that beginning with [REDACTED] the unpaid losses computed on the discounted basis were the proper amounts to be taken into account for federal income tax purposes. 0832.06-00.

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### CONCLUSION

For the reasons discussed below, we agree with your views that the positions taken by the Service as to these issues would not be sustained in litigation, and that both issues should be conceded by the Commissioner in this case.

### DISCUSSION

#### Issue (1). Downward Adjustments to Taxpayer's Unpaid Losses on the Basis of Application of the "Closed Claim" Method of Testing Unpaid Losses

##### Facts

Taxpayer, as a casualty insurance company, maintains as of the end of any particular year a liability account for "unpaid losses" (i.e., losses which have been incurred under insurance coverage issued by it, but which it has not yet paid). The unpaid losses consist of two components: the "case" claims (which are claims which have been reported to it), and losses which have been incurred, but which have not yet been reported to taxpayer ("IBNR" losses).

The Service upon audit of taxpayer's [REDACTED] through [REDACTED] taxable years determined that the unpaid loss amounts claimed by taxpayer for those years in the computation of "losses incurred" under I.R.C. section 832(b)(5) were excessive. The Service arrived at that determination by testing taxpayer's unpaid losses for the years [REDACTED] through [REDACTED] on a line-by-line basis using the so-called "closed claim" method. In testing those unpaid losses the Service first determined with respect to each line of business the amounts of case claims as of the end of each of the years [REDACTED] through [REDACTED] which were closed as of [REDACTED]. Next, the Service determined how much was paid on those various closed case claims, minus salvage and subrogation actually recovered, and reinsurance recovered or recoverable thereon, through [REDACTED]. For each line of business the aggregate of the closed claims in that line for the six test years was divided by the aggregate of the net payments thereon (i.e., the amount paid, minus salvage and subrogation actually recovered and reinsurance recovered or recoverable) to produce an "experience rate" for each line of business. The unpaid losses (which include case claims and IBNR losses) for each line of business at the close of each of the years [REDACTED] through [REDACTED] were divided by the experience rate applicable to that line of business, and the aggregate of the line-by-line results was deemed to be the allowable amount of the unpaid losses as of the end of the year in question. For each of the years [REDACTED] through [REDACTED] the Service determined that the unpaid losses claimed by taxpayer were overstated.

Further data regarding loss development for the test years [REDACTED] through [REDACTED] are contained in exhibits to taxpayer's protest. Exhibit 2-A thereof indicates that as to taxpayer's unpaid loss reserves for each of the test years [REDACTED] through [REDACTED] the aggregate losses actually paid (net of salvage and subrogation recovered and reinsurance recovered or recoverable) as of [REDACTED], exceeded the unpaid loss reserve (which, as stated above, was comprised of case claims and IBNR losses). The ratio of the aggregate unpaid loss reserves for the years [REDACTED] through [REDACTED] to the aggregate cumulative losses actually paid through [REDACTED] was [REDACTED]. Moreover, substantial amounts of unpaid losses for the test years remained outstanding as of the end of [REDACTED]. The Service's determination that unpaid losses for the test years were overstated was based solely upon the fact that for the test years the unpaid loss reserves for claims which were closed as of the end of [REDACTED] were, in fact, overstated. That overstatement was determined only on the basis of closed case claims. However, in making the adjustment at issue, the Service assumed that a similar degree of overstatement existed with respect to the case claims still open as of the end of [REDACTED] and also with respect to the IBNR portion of unpaid losses. As indicated by the data in the exhibits to taxpayer's protest, when the payments with respect to the IBNR losses (which payments were far greater than the IBNR reserves) and partial payments on still open case claims are taken into account, the aggregate losses paid for the test years substantially exceed the aggregate unpaid loss reserves, indicating that those reserves were, in fact, understated.

Exhibit 2-A indicates that losses paid as of [REDACTED], on case claims were less than case unpaid losses for [REDACTED], and [REDACTED], and were more than case unpaid losses for [REDACTED], and [REDACTED]. However, when the [REDACTED] years are aggregated, the cumulative paid losses on case claims exceed the case unpaid loss reserves. The difference between this fact and the Service's finding that the case losses were overstated was attributable to the failure of the Service to take into account partial payments on still-open case claims. The data contained in Exhibit 2-A indicate that, in the aggregate, the still-open case claims were understated. Also, for each of the test years [REDACTED] through [REDACTED], the payments through [REDACTED] with respect to IBNR losses exceeded the IBNR reserves.

As shown in Exhibit 2-A, in the aggregate for the years [REDACTED] through [REDACTED] the ratio of amounts paid on closed case claims as of [REDACTED], to the cumulative amounts paid as of [REDACTED], with respect to unpaid losses is [REDACTED]. This indicates that the loss payments taken into account by the Service in its use of the closed claim method constituted less than one-half of the total amounts paid with

respect to the unpaid losses in question. As also shown in Exhibit 2-A, the [REDACTED]-year aggregate ratio of closed case claims to total case claims is [REDACTED], whereas the ratio of amounts paid on closed case claims to amounts paid on all case claims is [REDACTED], indicating that proportionally more in losses was being paid with respect to open case claims than was paid with respect to closed case claims. Thus, the Service's failure to take into account partial payments on open claims distorted the results of its testing of the loss development for the years [REDACTED] through [REDACTED].

Exhibit 2-C sets forth in column (C) thereof for each line of taxpayer's business the ratio of the aggregate of taxpayer's [REDACTED] through [REDACTED] unpaid loss reserves for that particular line of business to the aggregate of losses paid through [REDACTED] with respect to unpaid losses for the years [REDACTED] through [REDACTED] (net of salvage and subrogation recovered and reinsurance recovered or recoverable). In the exhibit the factor so derived for each line of business is divided into taxpayer's unpaid loss reserve amount for that particular line of business for each of the taxable years [REDACTED] through [REDACTED] (the years in suit). The adjusted unpaid loss reserves for the various lines of business as so adjusted are then added together for each year in the exhibit to yield an adjusted unpaid loss amount for each of the years [REDACTED] through [REDACTED]. As indicated in the exhibit, the unpaid losses as so adjusted exceed the unpaid losses claimed by taxpayer in each of the years [REDACTED] through [REDACTED] by amounts ranging from approximately \$[REDACTED] to \$[REDACTED].

#### Legal Analysis

Section 832 of the Internal Revenue Code provides, in effect, that the increase or decrease for the taxable year in unpaid losses is to be taken into account in the computation of the deduction for losses incurred. Section 1.832-4(a)(5) of the Regulations provides that "[i]n computing 'losses incurred' the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them." Section 1.832-4(b) of the Regulations goes on to state as follows:

Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's

experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

Revenue Procedure 75-56, 1975-2 C.B. 596, states as follows:

Unpaid losses outstanding at the end of the taxable year taken into account in computing the deduction for losses incurred shall be the aggregate of the reasonable estimates for each line of business at the end of the taxable year. Such reasonable estimates for each line shall be made on the basis of the facts in each case or claim in that line and the company's experience with similar cases or claims whether or not presently in that line. The estimates for each line of business shall be separately tested on such basis to determine whether the estimate of unpaid losses for that line is reasonable. After the estimates of every line of business are adjusted upward or downward, as appropriate, then such estimates are aggregated to arrive at the total adjusted estimate of unpaid losses. [Emphasis added].

The question of whether unpaid loss reserves as claimed by a casualty insurance company are allowable under I.R.C. section 832(b)(5) is a coordinated issue within the examination function, and we are enclosing herewith a copy of the position paper relative to that issue, wherein is discussed the closed claim method of testing unpaid loss reserves utilized by the Service in the instant case. As is indicated therein, the closed claim method was advocated as a preferable alternative to a method of testing unpaid losses which would include in the loss development taxpayer's estimate of losses still remaining unpaid. As is

discussed in that position paper, the inadequacy which the closed claim method sought to remedy was the use of estimates (i.e., remaining unpaid losses) as part of the loss development used to verify the unpaid losses in question, which are themselves estimates. By recognizing only actual payments in the development of unpaid losses, the closed claim method was thought to result in a more accurate development of unpaid losses. However, as indicated in the discussion on page 5 of the position paper, the basic question is whether the unpaid losses claimed by a taxpayer were reasonable, and it is recognized that the results of application of the closed claim method may be rebutted by evidence establishing the reasonableness of the reserves.

Accordingly, it appears that, although the closed claim method was perceived as one generally yielding reliable and accurate results, it was never considered to be fool-proof or applicable to every situation no matter how unreasonable the results. Where, as in this case, the net losses actually paid with respect to the unpaid loss reserves for the test years exceed those reserves, it would seem entirely unreasonable to nevertheless contend, on the basis of the results of application of the closed claim method, that such reserves were excessive. Under the circumstances of the instant case, the results of the closed claim method, based on development of only a portion of the unpaid loss reserves for the test years, are conclusively rebutted by the more complete and accurate loss development information detailed in the exhibits to taxpayer's protest. Use of the closed claim method is mandated neither by statute nor regulation, and use of such method is supportable only in cases where the facts do not show the method to be unreasonable.

Moreover, the circumstances which exist in the instant case, and which generate distorted results in use of the closed claim method, apparently are common enough to raise serious doubts as to the usefulness of the method applied by the Service in this case. In this regard, we are enclosing copies of pages 90 through 94 of the ISP [Industry Specialization Program] Digest of August 1985. As discussed at page 92 through 94, the Industry Specialist for the casualty insurance industry recommends that the Service's examining agents, in applying the closed claim method, do so with several modifications aimed at remedying precisely the problems presented by use of the method in the instant case. Thus, it is recommended that the loss development for the test years take into account partial payments on

remaining open claims, and also payments with respect to IBNR losses. Application of the closed claim method with such modifications to the facts of the instant case yields precisely the results detailed in Exhibit 2-C to taxpayer's protest. In other words, the actual loss development for the test years indicates an overall understatement of unpaid loss reserves for the years in suit. Moreover, it should be noted that the modifications suggested in the ISP Digest include the recommendation that the loss experience figures include an adjusted reserve for the remaining liability on open claims. If such adjusted reserve amounts had been taken into account in the computations reflected in Exhibit 2-C, even greater reserve understatements would have been indicated.

The Industry Specialist for the casualty insurance industry, Mr. Ben DiCenso of the Boston District, informed our Mr. Ross Rowley in a telephone conversation of [REDACTED] that the recommended changes to the closed claim method were approved by the Commissioner in April of this year, and that Mr. DiCenso is in the process of revising the position paper on this issue accordingly. Thus, it seems that, assuming the correctness of the data reflected in the pertinent exhibits to taxpayer's protest, the taxpayer has rebutted the results of the Service's application of the closed claim method and that, even under the position paper statement of the method relied upon by the Service, taxpayer's unpaid losses should have been allowed in the amounts claimed. However, regardless of Service position on the closed claim method at the time this case was being developed, the recent modifications to that method accord entirely with taxpayer's position as to the reasonableness of the unpaid losses claimed by it. Finally, we believe that the facts of this case so overwhelmingly establish the reasonableness of the claimed unpaid loss amounts that the Commissioner would have no chance of being sustained on the adjustments in question. Accordingly, we concur in your views that this issue should be conceded by the Commissioner.

Issue (2). Discount Factor in Computing Unpaid Losses on Workmen's Compensation [REDACTED] Claims

Facts

As part of its workmen's compensation line of business, taxpayer has underwritten, both directly and through reinsurance, workmen's compensation risks involving "[REDACTED]" claims. Prior to [REDACTED], taxpayer estimated unpaid losses on [REDACTED] claims as the aggregate of the amount of loss payments expected to be made in future years in respect of such claims. Those estimates were made without the application of any discount

factor. However, commencing in [REDACTED], taxpayer changed its method of accounting for estimated unpaid losses on [REDACTED] claims for annual statement purposes. In [REDACTED] and thereafter taxpayer applied a discount factor of [REDACTED] percent compounded annually to unpaid losses on [REDACTED] claims in computing the amounts of unpaid losses thereon reported in its annual statement. For federal income tax purposes, however, taxpayer continued to claim unpaid losses computed without application of a discount factor. The Service disallowed unpaid losses on [REDACTED] claims in an amount equal to the difference between the unpaid losses computed for federal income tax purposes and the unpaid losses computed for annual statement purposes.

#### Legal Analysis

It has been held with respect to taxpayers other than insurance companies that where the taxpayer changes its method of accounting for regulatory or book purposes, the taxpayer may, for tax purposes, continue to use the method theretofore utilized in its tax computations, so long as the federal tax method clearly reflects income and whatever adjustments are required to convert between the two methods may be readily verified from the taxpayer's permanent books and records. Patchen v. Commissioner, 258 F.2d 544 (5th Cir. 1958), rev'd 27 T.C. 592 (1956); Rev. Rul. 74-383, 1974-2 C.B. 146; Rev. Rul. 68-35, 1968-1 C.B. 190; Rev. Rul. 68-83, 1968-1 C.B. 190; Rev. Rul. 67-147, 1967-1 C.B. 105. We know of no authority for imposing with respect to insurance companies a different rule of conformity of the tax method with the method used for book or regulatory purposes. Service position with respect to casualty insurance companies is that, in this regard, the annual statement "is a guide only and is not controlling for Federal income tax purposes." Rev. Proc. 75-56, 1975-2 C.B. 596. As you pointed out in your memorandum of March 10, 1986, requesting technical advice on this issue, the Service has in the past affirmatively disallowed insurance companies' requests to change their federal tax accounting method to conform with a change for book purposes from an undiscounted to a discounted method of computing unpaid losses. Relying upon the language of Treas. Reg. section 1.832-4(b) that unpaid losses include "only actual unpaid losses stated in amounts which, based on the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay," the position has been taken in disallowing such requests for change in method that the Code and Regulations do not even permit a casualty insurance company to compute unpaid losses on a discounted basis. In addition to the letter of [REDACTED] forwarded with your technical advice request, see letter of




██████████, with respect to the Illinois State Medical Inter-Insurance Exchange, enclosed with this memorandum. Regardless of the correctness of that position, it seems clear that an undiscounted method of computing unpaid losses is an acceptable method under I.R.C. section 832(b)(5). Since the use of the undiscounted method by the instant taxpayer apparently cannot be attacked as not clearly reflecting income, and apparently can be easily reconciled with the discounted amounts computed for book purposes, we know of no basis for not allowing the taxpayer to continue to use the undiscounted method for tax purposes in the years in suit. There would seem to be no more of a requirement of conformity between book and tax accounting methods in the case of unpaid losses of a casualty insurance company than exists with respect to taxpayers generally.

In light of the foregoing, we agree with your conclusion that the issue should be conceded in the instant case.

If we can be of further assistance please inform us. We are returning herewith the legal file forwarded with your memorandum of March 10, 1986.

ROBERT P. RUWE  
Director

By:

  
DANIEL J. WILES  
Chief, Branch No. 3  
Tax Litigation Division

Enclosures:

Legal file  
IRS ltr. to Illinois State Medical  
Inter-Insurance Exchange dated  
██████████  
IRS position paper  
ISP Digest of August 1985, pp. 90-94